DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 04-0050
GROSS RETAIL TAX
For 2001

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ISSUE

I. **Aircraft Purchase** – Gross Retail Tax.

Authority: IC 6-2.5-4-10(a); IC 6-2.5-4-10(b); IC 6-2.5-2-1; IC 6-2.5-5-1 to 70; IC 6-2.5-5-8; Gregory v. Helvering, 293 U.S. 465 (1935); Horn v. Commissioner of Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); 45 IAC 2.2-4-27(a); 45 IAC 2.2-4-27(c); 45 IAC 2.2-4-27(d); 45 IAC 2.2-4-27(d)(1); 45 IAC 2.2-5-15(b)(1), (c)(2); Blacks Law Dictionary (7th ed. 1999).

Taxpayer argues that the Department of Revenue (Department) erred when it determined that the aircraft it bought in 2001 was not purchased for an exempt purpose and that – as a result – taxpayer now owes gross retail (sales) tax on the initial purchase price of that aircraft.

STATEMENT OF FACTS

Pilot/lessee organized and invested money in a Nevada Limited Liability Company (LLC). The LLC (hereinafter "taxpayer") bought an aircraft in January of 2001. The selling price of the aircraft was approximately $1,500,000. Taxpayer traded in another airplane worth approximately $600,000 and paid the dealer the $900,000 difference. Taxpayer paid no sales tax on the $900,000 claiming that the "the aircraft is purchased by a retail merchant to be rented or leased to others as provided in IC 1971-6-2.5-5-8." The pilot/lessee signed the Indiana "Application for Aircraft Registration or Exemption" listing the taxpayer as the owner of the aircraft and signing individually as the "Authorized Person." On that application, taxpayer specified that the purchase was exempt from sales tax because it was purchased for "Rental or Lease to others per IC 1971-6-2.5-5-8."

Prior to the date of the purchase, taxpayer and pilot/lessee entered into an "Aircraft Lease" agreement which was dated December 2000. Pilot/lessee signed the document indicating that he was the "lessee." Pilot/lessee signed the document – on behalf of taxpayer – indicating that he was the "lessor."

In September of 2003, the Department sent taxpayer a letter in which it sought documentation verifying that the aircraft was purchased for an exempt purpose. The Department asked for flight schedules, flight logs, and for a copy of the lease agreement.

Taxpayer – through its representative – responded in November providing a signed copy of the lease and indicating that a lease payment of $5,000 was made during 2001 and a second lease payment of approximately $7,000 was made during 2002.

The Department responded that same month "disallowing the exemption claimed for rental/leasing of the aircraft . . . as the lease agreement submitted contains a rental rate of $75 per hour for use of the aircraft." The Department indicated that it had verified with another aircraft dealer that a "fair market" hourly lease rate would be "substantially higher" than the $75 paid by pilot/lessee. In addition, the Department questioned whether the lease agreement was an "arms-length" transaction and noted that pilot/lessee had signed the agreement as both lessee and lessor. In its letter, the Department concluded that the aircraft was not purchased for an exempt purpose but that the lease "transaction is most beneficial to [pilot/lessee] at the expense of the State of Indiana." Accordingly, the Department indicated that it intended to propose an assessment for sales tax based on the original purchase price of the aircraft with an allowance made for the trade-in value of the predecessor airplane.

That same month, the Department sent taxpayer a notice of "Proposed Assessment" indicating that taxpayer owed approximately $50,000. That amount consisted of the original sales tax amount, a ten-percent penalty, and an additional amount of interest which had accumulated since the time that the aircraft was first purchased.

In January of 2004, taxpayer's representative responded, challenging the proposed assessment on the ground that the Department misunderstood or misinterpreted the terms of the parties' lease agreement. Taxpayer admitted that, under the terms of the agreement, pilot/lessee was required to pay taxpayer only $75 for each hour pilot/lessee used the aircraft. However, pilot/lessee was also required – under the terms of the lease agreement – to pay the costs of providing fuel, maintaining and repairing the aircraft, insuring the aircraft, and hangering the aircraft. Therefore, while only $75 was ever paid by the pilot/lessee each time he used the aircraft for an hour, the pilot/lessee's actual hourly costs were considerably greater than the $75 base rate. After factoring in fuel, repair, maintenance, insurance, and hanger expenses, the pilot/lessee purportedly spent approximately $630 for every hour the pilot/lessee used the aircraft. According to taxpayer, this $630 amount represents the "fair market value based on similar transactions between unrelated parties."

DISCUSSION

I. **Aircraft Purchase** – Gross Retail Tax.

Taxpayer maintains that the Department erred in concluding that the aircraft was not purchased for the purpose of leasing it to other persons and concluding that taxpayer should now be required to pay sales tax on the original purchase price of that aircraft.

Indiana imposes a gross retail (sales) tax on retail transactions in Indiana. IC 6-2.5-2-1. The state legislature has provided a number of exemptions to the imposition of that tax. *See* IC 6-2.5-5-1 to 70. One of those exemptions is found at IC 6-2.5-5-8 which states that, "Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of his business without changing the form of the property."

Therefore, if taxpayer bought the aircraft for the purpose of leasing it to others, taxpayer was not required to pay sales tax on the purchase price because taxpayer bought the plane for "an exempt purpose."

However, once a person – such as taxpayer – gets into the business of leasing tangible personal property, that person is required to collect sales tax on the lease payments. IC 6-2.5-4-10(a) states that, "A person, other than a public utility, is a retail merchant making a retail transaction when he rents or leases tangible personal property to another person."

The Department's regulation defines what it is that a person in the leasing business should be collecting sales tax on. 45 IAC 2.2-4-27(a) states that, "In general, the gross receipts from renting or leasing tangible personal property are taxable. This regulation [] only exempts from tax those transactions which would have been exempt in an equivalent sales transaction."

The regulation further defines "gross receipts" obtained from leasing tangible personal property. "The rental or leasing of tangible personal property, by whatever means effected and irrespective of any terms employed by the parties to such transaction is taxable." 45 IAC 2.2-4-27(d).

For the benefit of those lessors who may find that the above language is in any way ambiguous, the regulation further states that, "The amount of actual receipts means the gross receipts from the leasing of tangible personal property without any deduction whatever for expenses of costs incidental to the conduct of the business. The gross receipts include any consideration received from the exercise of an option contained in the rental [or] lease agreement . . . ." 45 IAC 2.2-4-27(d)(1).

Taxpayer has a lease agreement with pilot/lessee. The agreement calls for pilot/lessee to pay taxpayer $75 for every hour that pilot/lessee uses the aircraft. In addition, the agreement requires that pilot/lessee assume the costs of operating, maintaining, and storing the aircraft. According to taxpayer's representative, because those costs – together with the $75 base rental – average out to approximately $630 per hour, pilot/lessee is paying a fair market price for the cost of using the aircraft even though taxpayer only reports $75 of that amount as subject to sales tax.

When a lessor rents tangible personal property it must collect sales tax on the "gross receipts" received. 45 IAC 2.2-4-27(c). The amount of the tax liability is never affected by the terms of the parties' lease agreement. As stated in the regulation, "The rental or leasing of tangible personal property, by *whatever means effected and irrespective of the terms employed* by the parties to describe such transaction, is taxable." 45 IAC 2.2-4-27(d) (*Emphasis added*). The term "gross receipts" means, "The total amount of money or other consideration received by a business taxpayer for goods sold or services performed in a year, before deductions." Black's Law

Dictionary 710 (7th ed. 1999). The gross receipts means the amount of consideration received by the lessor "without any deduction whatever for expenses or costs incidental to the conduct of the business." 45 IAC 2.2-4-27(d)(1).

Nevertheless, taxpayer neatly side-steps this provision because taxpayer does not appear to deduct anything from the $75 base hourly rate. Taxpayer – in effect – argues that the Department should accept the proposition that it is renting a million-dollar-plus aircraft for $75 an hour and be content with collecting $3.75 in sales tax on that base amount. However, taxpayer's somewhat far-fetched argument fails because taxpayer is overlooking a major portion of the consideration it receives when it rents the aircraft to pilot/lessee and because taxpayer ignores the fact that it is required to collect sales tax on "any consideration" obtained as a result of the lease agreement between itself and pilot/lessee. "Consideration" is defined as "[s]omething of value (such as an act, a forbearance, or a return promise) received by a promisor from a promisee." Black's Law Dictionary 300 (7th ed. 1999). In the parties' lease agreement, taxpayer is receiving additional consideration from pilot/lessee beyond the $75 hourly base fee. Pilot/lessee is promising to pay for the entire cost of insuring, maintaining, and operating an aircraft which pilot/lessee does not own. Taxpayer owns this aircraft; therefore the fact that the pilot/lessee pays for all the variable expenses attendant upon the operation and ownership of the aircraft is a substantial benefit which flows in taxpayer's direction. The cost of the variable expenses is one portion of the consideration which taxpayer received in exchange for which taxpayer granted pilot/lessee the right to use taxpayer's aircraft. Therefore, taxpayer should have been collecting and paying sales tax on the total amount of consideration it received from pilot/lessee which would have included the $75 base fee and the amount of money pilot/lessee spent on taxpayer's behalf in maintaining and operating the aircraft.

Nonetheless, whether taxpayer should have been collecting sales tax on a $75 or $630 hourly rate is finally irrelevant because there simply is no lessee/lessor relationship here. As a matter of law and simple common sense, there is no "lessee" and there is no "lessor." The taxpayer and the pilot/lessee are wholly identical parties and the purported lease agreement is an entirely transparent effort to avoid sales tax liability. As such, the Department is entitled to entirely ignore the lease agreement and to treat – for tax purposes – the initial acquisition of the aircraft as undertaken for a non-exempt purpose because the self-styled "Aircraft Lease" agreement falls squarely within the definition of a "sham transaction." The "sham transaction" doctrine is long established both in state and federal tax jurisprudence dating back to Gregory v. Helvering, 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id at 469. A business activity undertaken merely for the purpose of avoiding taxes was without substance and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id at 470. The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied,* 338 U.S. 955 (1950). "[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to

secure the attached tax benefit" but are devoid of any economic substance. Horn v. Commissioner of Internal Revenue, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992).

The Department was correct in determining that taxpayer owed sales tax on the initial purchase price of the aircraft because taxpayer was never engaged in leasing the aircraft in the ordinary course of its business. *See* IC 6-2.5-4-10(b); 45 IAC 2.2-5-15(b)(1), (c)(2). The "Aircraft Lease" agreement was not an agreement to rent or lease an airplane but was a fanciful document drafted "for no other motive but to escape taxation." Transp. Trading and Terminal Corp., 176 F.2d 570, 572. The parties' lease agreement has no economic substance or rationale and, for purposes of determining sales tax liability, should be entirely ignored.

FINDING

Taxpayer's protest is respectfully denied.

DK/JM/MR – 042503